State Bank of Pakistan

Banking Supervision Department

Quarterly Performance Review of the Banking System

March 2004

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1 Overview

The results for the quarter-ended March 31, 2004 indicate that the banks will have to work hard and apply considerable skill and innovation to come close to the results achieved during the previous year.

The advent of the new year witnessed continuing upward trend in yields on government securities; a much awaited development from the banks' perspective which left them with the fast disappearing capital gains on their books. On the other hand, the prevailing excess liquidity and stiff competition in lending to credit-worthy borrowers coupled with increasing reliance of large companies on non-bank sources for meeting their funding needs, has seriously impaired the banks' ability to effect a similar rate hike on their loan portfolio; the weighted average returns on which has dropped to 4.69 percent in March 04 from 5.68 percent of Dec-03.

While this poses considerable challenge to banks, continuing influx of funds, an increase of Rs66.1 billion in deposits during the quarter ended March 04, also has some respite in the form of corresponding increase in the portfolio of earning assets. This largely helped the banks to remain on the profitability course, albeit with some moderation in their profitability ratio. Commercial banks' decline was more modest with their profit for the quarter equalling 24 percent of their last year's profits (annualized ROA 1.1 percent as against 1.2 percent of Dec-03). What makes this profit even more encouraging is that it mainly comprises core incomes, as trading gains have declined.

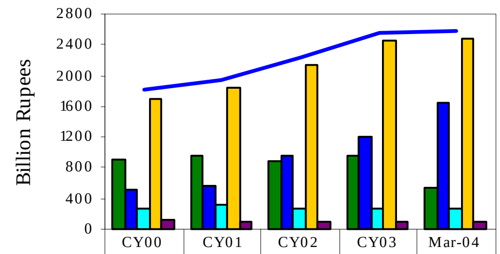
The banks' credit portfolio expanded further by Rs41.4 billion showing sustained demand even in the periods when it usually declines. This robust growth also has some associated concern but there is no indication as yet to suggest any significant impairment in credit quality.

The solvency position of the banking system slightly improved over the quarter; however, the major contributing factor was improvement in one of the largest specialized bank. The impact of the phenomenal growth in credit during the quarter was largely neutralized by profits earned during the quarter, and as a result the commercial banks were able to maintain their CAR intact.

2 Sources and Uses of Funds

The asset base of the banking sector follows a seasonal pattern over the year. On the back of higher demand for bank credit, banks' operations witness remarkable expansion in the Oct-Dec quarter. After reaching an apex by the end of the quarter, the loan portfolio starts declining in the wake of retirement of seasonal credit. The first quarter of 2004, however, marked the breaking away from this sluggish phase of the cyclical pattern. Loans witnessed a significant growth of 3.3 percent over the quarter. This growth was well supported by expansion in the deposit base of banks, which grew by Rs66.1 billion, or 3.4 percent. Since the banks used a substantial part of the additional inflow of deposits to settle their inter-bank obligations, growth in overall assets base remained minimal at 1 percent (see **Figure-2.1**), while the growth in loans changed the asset mix as well (see **Table-2.1**).

Figure2.1: Assets of the Banking System



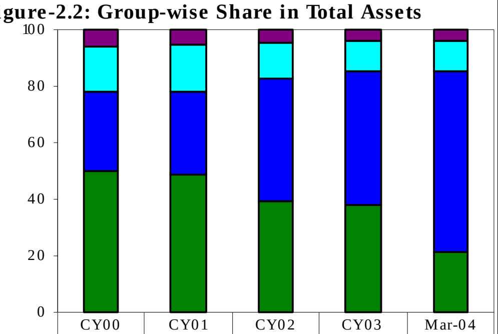
	CY00	CY01	CY02	CY03	Mar-04
PSCBs	902.0	946.5	877.6	963.1	544.7
LPBs	513.5	565.9	967.5	1,211.6	1,654.0
FBs	280.6	323.7	279.6	271.2	271.5
All CBs	1,696.1	1,836.1	2,124.6	2,446.0	2,470.2
SBs	111.5	106.2	98.5	100.0	100.7
All	1,807.6	1,942.3	2,223.1	2,546.0	2,570.9

Table 2.1: Major Sources and Uses of Funds

(Percent)	CY00	CY01	CY02	CY03	Mar-04
Source					
Deposits	74.2	75.9	75.3	77.1	78.9
Borrowings	14.8	13.8	12.5	11.8	9.9
Equity	4.5	3.8	4.8	5.4	5.8
Others	6.5	6.5	7.3	5.7	5.4
Total	100	100	100	100	100.0
Uses					
Loans	49.1	46.9	41.5	43.5	44.6
Investments	16.8	18.1	31.5	30.9	31.3
Others	34.0	35.1	27.0	25.5	24.1
Total	100	100	100	100	100

Group wise, upon its privatization, the shift of HBL from PSCBs to LPBs led to a remarkable increase in the asset base and the relative share of LPBs. This sector spearheaded the industry's expansion. Taking out the effect of HBL's category shift, total assets of LPBs grew by 1.5 percent, while its deposits and loans grew by around 4 percent each. The combined effect of HBL's privatization and the growth in LPBs asset base, expanded their market share from 47.6 percent to 64.3 percent (see **Figure-2.2**). The asset base of the PSCBs, excluding the effect of HBL's category shift, remained almost stagnant. The FBs

Figure-2.2: Group-wise Share in Total Assets



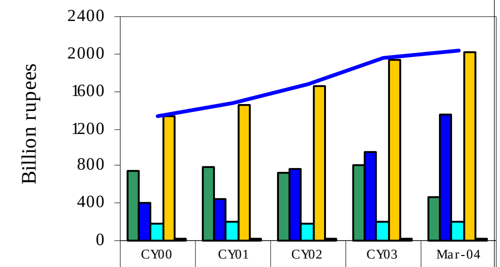
	CY00	CY01	CY02	CY03	Mar-04
SBs	6.2	5.5	4.4	3.9	3.9
FBs	15.5	16.7	12.6	10.7	10.6
LPBs	28.4	29.2	43.5	47.6	64.3
PSCBs	49.9	48.8	39.5	37.8	21.2

followed the same pattern; however, their lending portfolio registered a phenomenal growth of 7.0 percent which changed their asset mix significantly.

2.1 Deposits

The flow of funds into the banking system continued at a persistent rate during the quarter as well. Deposits grew by Rs66.1 billion (3.4 percent) vis-à-vis 4.0 percent growth in the preceding quarter (see **Figure-2.3**). This growth, like in previous quarters, was well supported by external sources as foreign remittances showed signs of improvement and amounted to slightly higher than the preceding quarter's figure.

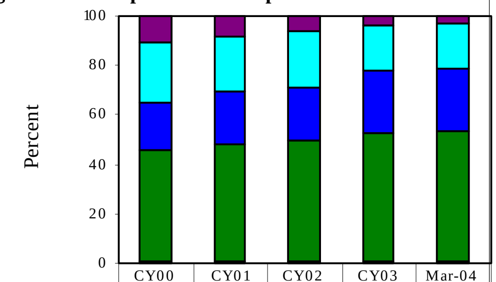
Figure-2.3: Deposits of the Banking System



	CY00	CY01	CY02	CY03	Mar-04
PSCBs	743.7	795.2	721.9	799.4	466.3
LPBs	394.2	453.7	757.4	952.5	1,350.0
FBs	187.4	207.8	182.8	193.8	196.4
CBs	1,325.3	1,456.7	1,662.1	1,945.8	2,012.6
SBs	15.6	18.0	16.3	16.9	16.2
All	1,340.9	1,474.7	1,678.4	1,962.7	2,028.8
Domestic All	1,159.0	1,308.4	1,536.7	1,804.8	1,883.0

The major share of growth in deposits i.e. 92.8 percent was contributed by local deposits. This contribution also corresponds to their share in overall deposits. The currency composition of deposits has been tilting towards the Pak rupee and the quarter under review witnessed further strengthening of this trend. Foreign currency deposits, barring overseas deposits, shrank and their share in total deposits reduced by 50 basis points to 14.9 percent (15.4 percent in CY-03). Besides shift in the currency composition of deposits, their composition by type also moved towards less costlier types. Being the most rate sensitive of all types, fixed deposits contracted by 1.7 percent during the quarter. Saving deposits grew by a phenomenal amount at Rs52.4 billion or 5.2 percent. Consequently the share of saving deposits in the overall deposits composition further strengthened by 90 basis points to 52.6 percent (see **Figure-2.4**). Similarly, the share of current account deposits improved

Figure-2.4:Composition of Deposits

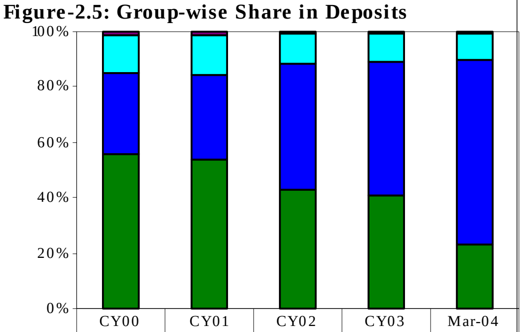


	CY00	CY01	CY02	CY03	Mar-04
From Fin. Instit.	10.4	8.8	6.5	3.8	3.4
Fixed Deposits	24.9	22.1	22.5	18.5	17.6
Current Accounts	19.2	21.4	21.3	25.4	25.8
Saving Deposits	44.9	47.3	49.1	51.7	52.6
Others	0.6	0.5	0.5	0.7	0.6

slightly. In the wake of an upturn in economic activity and lending volume, these deposits posted a substantial increase of Rs26 billion or 5.2 percent.

Sector wise, LPBs - which now dominate the banking sector, also led deposit mobilization during the quarter. Their deposit base increased by Rs52 billion[1] (4 percent) and the privatization of HBL substantially pushed up their market share to 66.5 percent (see **Figure-2.5**). PSCBs and FBs also managed to build up their deposit base by 2.7 percent and 1.3 percent, respectively.

Figure-2.5: Group-wise Share in Deposits



	CY00	CY01	CY02	CY03	Mar-04
SBs	1.2	1.2	1.0	0.9	0.8
FBs	14.0	14.1	10.9	9.9	9.7
LPBs	29.4	30.8	45.1	48.5	66.5
PSCBs	55.5	53.9	43.0	40.7	23.0

2.2 Borrowings

On an aggregate basis, borrowings of the banking sector declined by Rs45 billion (15 percent). The major decline was observed in the Inter-bank-Repo borrowing, which was touching unprecedented levels at the beginning of the quarter. This elevated level of borrowing reverted to normal in the end of the quarter by shedding Rs58.9 billion. Quarter-on-quarter results show a 3.2 percent surge in export refinance borrowing. This was a natural outcome to the country's improved export performance. In addition, by keeping rates intact on refinance in a stabilizing rate scenario, the SBP strengthened the demand for these borrowings.

The quarter under review continued to experience the long prevalent easy liquidity environment. The improved demand for bank credit enabled the banking sector to deploy a part of its surplus liquidity in the form of loans. Overall, the banking sector remained sufficiently liquid as there were only a few recourses to the State Bank's discount window. The State Bank's OMOs were mainly focused on mopping up excess liquidity. Unlike the previous quarter's heavy injections through OMOs, this quarter was devoid of any liquidity injection.

2.3 Loans

The improved economic activity in the economy has had a healthy effect on the demand for bank credit. Contrary to the established sluggish trend for the Jan-March quarter whereby loans were used to witness retirement in the wake of slackness in

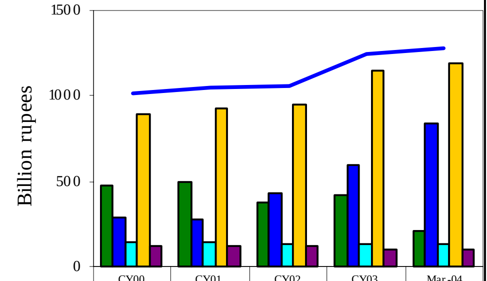
[1] *Excluding the effect of HBL's category shift*

cotton activity, loans of the banking sector in this quarter registered an increase of Rs41.4 billion. All this increase was contributed by domestic operations as overseas operations, which form around 6 percent of the total loan portfolio, came down by Rs3.5 billion (see **Figure-2.6**).

In addition to the upbeat trend in economic activity in the country, the prevailing easy monetary regime was a major boosting factor in lending growth during the quarter. The weighted-average lending rates reached their historically low levels by shedding one percentage point over the quarter (see **Table-2.2**).

Under the pressure of excessive liquidity and drying up of the lucrative avenue of government papers for placing excessive funds, banks have been moving increasingly into new areas. These areas were under-served till very recently. SME and consumer financing have been the focus of lending by banks for quite some time, and during the quarter under review lending to these sectors improved further. Lending to the SMEs sector surged by Rs10.2 billion (4.7 percent), while the growth in consumer finance was even more remarkable as this grew by Rs17.4 billion (26.6 percent). Automobile loans and miscellaneous personal borrowings remained the major focus of consumer finance. While mortgage

Figure-2.6: Loans of the Banking System



	CY00	CY01	CY02	CY03	Mar-04
PSCBs	475.7	501.0	374.2	421.4	214.0
LPBs	282.2	281.2	435.0	597.5	836.8
FBs	138.3	143.4	135.4	126.9	135.8
CBs	896.2	925.6	944.6	1,145.7	1,186.6
SBs	123.9	118.4	117.0	97.2	97.8
All	1,020.1	1,043.9	1,061.5	1,242.9	1,284.4
Domestic All	926.4	963.6	978.7	1,160.8	1,205.4

Table-2.2 : Interest Rate structure

(Percent)	CY00	CY01	CY02	CY03	Mar-04
Discount Rate	13.0	10.0	7.50	7.5	7.5
W.A. Lending Rates	13.88	13.4	10.31	5.68	4.69
W.A. Deposit Rates	5.23	4.96	3.6	1.32	1.30
Export Finance Rate	8	10	7	3	3
Export Refin. Rate	6	8.5	5.5	1.5	1.5
PIB rates					
3y	12.5	10.5	7	6	6
5y	13	11	8	7	7
10y	14	12	9	8	8
PIBs Yield *					
3y	12.45	10.49	4.56	3.93	3.73
5y	12.95	11	4.86	4.98	4.87
10y	13.97	11.92	5.52	6.21	6.45
T. Bill Rate wt.avg					
3m	10.23	7.65	3.9	1.46	1.52
6m	10.96	7.93	4.32	1.64	1.80
12m	11.49	8.4	4.36	1.99	2.00
T. Bill Rate cut off					
3m	10.23	7.65	3.9	1.48	1.57
6m	10.96	7.93	4.32	1.66	1.84
12m	11.49	8.4	4.36	1.99	2.05

** Information for Mar-04 are based on April 28, 2004 auction results*

Table-2.3 : Sector-wise Break Up of Loans-Mar-04
Domestic Operations

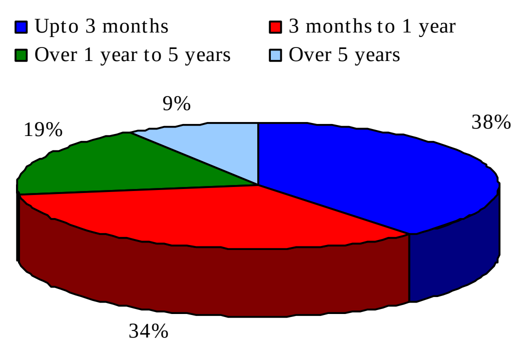
(Billion Rupees)	Dec-03		Mar-04	
	Amount	% age	Amount	% age
Corporate Sector	606.5	52.3	653.0	54.2
SMEs	215.0	18.5	225.2	18.7
Agriculture	104.7	9.0	102.7	8.5
Consumer Finance	65.6	5.7	83.0	6.9
Credit Cards	*8.9*	*0.8*	*9.7*	*0.8*
House Loans	*4.1*	*0.4*	*5.5*	*0.5*
Auto Loans	*22.2*	*1.9*	*27.6*	*2.3*
Other	*30.3*	*2.6*	*40.2*	*3.3*
Commodity Operations	90.3	7.8	*70.6*	*5.9*
Others	78.7	6.8	70.9	5.9
Total	1,160.8	100	1,205.4	100

loans in percentage terms show a substantial increase of 33 percent, these loans form a tiny portion of the overall lending portfolio. Although these newly emerging sectors improved their share in overall lending portfolio (see **Table-2.3**), the corporate sector, which is the traditional user of bank credit, absorbed the lion's share of the quarter's credit expansion. Lending to this sector increased by Rs46.5 billion. What is significant about this growth is the rise of Rs20.7 billion under the head of fixed investment. While this investment would boost economic activity on a more sustainable basis, this will, in turn, augment working capital demand in the coming days as well.

Along with improvement in the overall economy, the public sector and its enterprises showed improved performance too. Lending to the public sector declined by around Rs18 billion over the quarter, thereby leaving more funds for private sector investment in promising segments of the economy.

Looking at the sector wise composition of loans portfolio, LPBs were the most successful in credit expansion during the quarter. Keeping aside the effect of HBL's category shift, the lending of the sector increased by Rs33.2 billion. While foreign banks actively participated in credit expansion during the quarter registering a growth of Rs8.9 billion or 7.0 percent, the PSCBs remained passive in their lending portfolio, thereby suffering a contraction by Rs1.3 billion.

Figure-2.7: Maturity Profile of Loans-Mar-04



The banking sector in Pakistan traditionally caters to working capital and trade-finance requirements of its borrowers, and their exposure beyond the short term remains minimal. Although the financial reforms have opened up doors for banks to enter into longer-term high-earning project financing, with similar incentives coming through encouragement of mortgage finance, these developments have not yet affected the term structure of the loan portfolio. The long-term loans i.e. loans maturing over one year, form just 28 percent of the overall portfolio (see **Figure-2.7**). Plausible reasons for avoiding long-term financing include lacklustre demand for such funds in recent years as well as the low expertise of banks to properly assess and monitor the risks associated with longer term commitments. Another reason can be the lack of fund raising products that adequately match long term financing requirements of banks.

2.4 Investments

With liquidity finding its way into the core banking business, investments lost attraction as the only available avenue for deployment of funds. Thus, the trend of locking more assets into investments slowed down in the last couple of quarters.

During the quarter under review, the investments of the banking system increased by Rs16 billion or 2 percent as compared to 7.4 percent of the corresponding quarter of last year. Investment in government securities, which make up more than 80 percent of the total investment portfolio, witnessed almost the same level of growth (see **Table-2.4**).

Table-2.4: Total Investment of banking sector

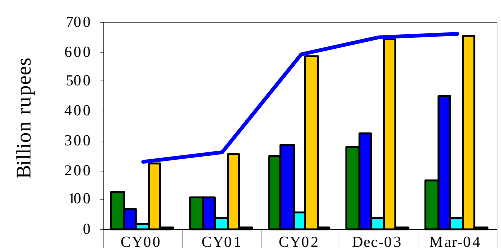
(Billion rupees)	CY00	CY01	CY02	Dec-03	Mar-04
Government papers:					
MTBs	95.8	126.6	373.9	399.6	405.4
FIBs	84.0	53.9	42.2	21.9	20.6
PIBs	2.0	42.0	116.7	180.0	179.4
Provincial Govt. Securities	1.7	1.6	1.4	0.2	0.2
Others	46.8	36.9	40.2	48.0	54.2
Equity investment *	16.0	25.4	29.0	42.0	44.0
TFCs, bonds, debentures and PTCs	40.7	49.0	55.5	68.4	73.4
Others	23.9	20.5	19.8	33.0	32.2
Total investment	311.0	356.0	678.6	793.1	809.4
Provision**	-6.6	-5.0	22.9	-5.0	-5.3
Total Net of Provision	**304.3**	**351.1**	**701.5**	**788.1**	**804.2**

*Including Investment in Subsidiaries and associate undertakings

** Provision as of CY02 includes surplus on revaluation as well

Investment in PIBs, which has remained the centre of investment during the falling interest rate scenario to lock in large capital gains, dropped by Rs0.6 billion over the quarter under review. This marked a shift in the preference to avoid capital losses, as yields on the new issues have started to pick up. Likewise, investment in MTBs, though up by 1.4 percent, remained sluggish due to the SBP's strategy of sticking to the maturities and setting low auction targets.

Figure-2.8: Investments in Fed. Govt. Securities



	CY00	CY01	CY02	Dec-03	Mar-04
PSCBs	129.8	106.2	246.1	280.3	166.4
LPBs	72.9	108.0	284.7	323.3	448.7
FBs	20.0	41.0	55.1	40.7	39.4
CBs	222.8	255.2	586.0	644.3	654.4
SBs	5.8	4.3	4.7	5.2	5.2
All	228.6	259.5	590.7	649.5	659.6

Group wise, the shift of HBL has surged the share of local private banks from around 50 percent during the last quarter to 67 percent in March-04. Their share in government papers surged by the same proportion (see **Figure-2.8**).

The exposure of banks to the public sector declined due to marked fall in credit to the public sector. However, the exposure of the banks in government papers remained intact (see **Table-2.5**).

Table- 2.5: Banks' Exposure to Public Sector

(Percent)	Dec-00	Dec-01	Dec-02	Dec-03	Mar-04
Credit	19.3	20.7	16.9	10	8.2
Total (Credit+Govt. papers)	36.6	35.5	44.3	39.9	38.2

Source: Weekly Statement

3. Performance of the Banking System

3.1 Capital Adequacy

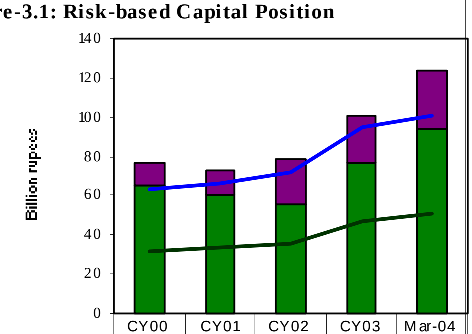
Solvency of the banking system got a favourable direction in March 04. This is reflected in the improved capital adequacy ratio of all banks, which increased to 9.8 percent as against 8.5 percent in CY03 (see **Table-3.1**). The main driver of this improvement was the strengthened capital position of specialized banks. Under a restructuring arrangement, the government's lending to the largest specialized bank was converted into capital for cleansing of losses and making up for capital shortfall. This also had a positive impact on the core capital to RWAs ratio of all banks, which improved to 7.5 percent from 6.5 percent in CY03.

Table-3.1: Capital Adequacy Indicators

Percent	CY00	CY01	CY02	CY03	Mar-04
CAR					
PSCBs	10.4	9.6	12.3	11.0	12.4
LPBs	9.2	9.5	9.7	9.0	9.3
FBs	18.0	18.6	23.2	23.0	21.1
Comm. Banks	11.4	11.3	12.6	11.1	11.1
SBs	-3.3	-13.9	-31.7	-28.2	-10.0
All banks	9.7	8.8	8.8	8.5	9.8
Tier 1 Capital to RWA					
PSCBs	7.7	7.1	8.6	8.16	9.3
LPBs	8.1	8.4	6.6	7.1	7.1
FBs	17.9	18.6	23.0	23.0	21.0
Comm. Banks	9.8	9.7	9.7	9.1	9.0
SBs	-3.4	-13.9	-31.7	-28.7	-15.5
All banks	8.3	7.3	6.2	6.5	7.5
Capital to Total Assets					
PSCBs	4.6	3.7	5.6	6.1	6.9
LPBs	3.5	3.8	5.2	5.1	5.7
FBs	8.8	8.5	10.6	10	9.9
Comm. Banks	4.9	4.6	6.1	6.0	6.4
SBs	-1.1	-10.3	-23.0	-9.5	-10.5
All banks	4.6	3.8	4.8	5.4	5.8

Capital adequacy ratio of all commercial banks on the other hand remained unchanged at 11.1 percent, despite profits during the quarter. Parallel growth in risk-weighted assets restricted further improvement in CAR of commercial banks. For the same reason, core capital to RWAs ratio of commercial banks shed around 8 basis points to 9 percent in this quarter. Unlike the negative growth in CY03, the supplementary capital of all banks witnessed positive growth during this quarter.

Figure-3.1: Risk-based Capital Position



	CY00	CY01	CY02	CY03	Mar-04
Tier II Capital	11.3	12.0	23.5	23.3	29.6
Tier I Capital	65.1	60.5	55.2	77.0	94.5
Required Tier I	31.5	33.1	35.9	47.3	50.5
Required Total	63.1	66.2	71.8	94.7	100.9

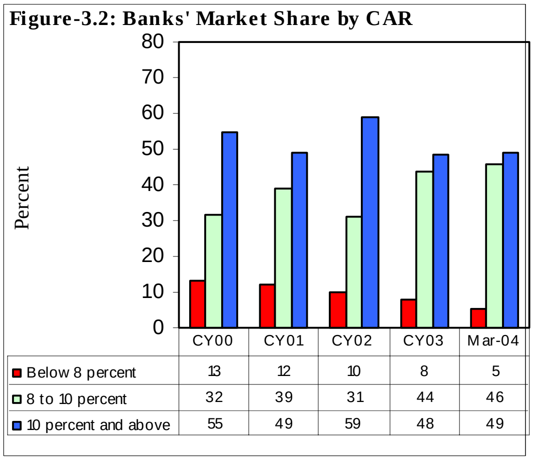
Figure-3.1 reflects the fact that positive developments continued during the quarter, with qualifying capital both Tier I and total, exceeding the required levels. As regards group wise position of the banks, all except foreign banks, recorded an improvement in their respective capital adequacy ratios. Irrespective of the fact that the percentage of risk based assets in terms of total assets rose for the major banking groups, the capital adequacy indicators presented a healthy picture. This was achieved on the back of augmented capital for all the banking groups in general and specialized banks in particular. Foreign banks have had their risk assets growing at a relatively faster pace hence resulting in slight deterioration in capital adequacy. Although the specialized banks are still giving negative capital ratios, the overall improvement in the solvency of the banking system during the quarter is mainly due to the significant improvement in the capital adequacy of the specialized banks.

In line with the improvement in overall capital adequacy position, most of the individual banks held capital cushion sufficiently above the required level. The banks improved their compliance status by meeting various regulatory requirements. As one of the specialized banks underwent restructuring aimed towards strengthening its capital, the number of non-compliant banks in terms of statutory capital requirement of Rs1 billion were reduced to 6. Besides, the number of banks not meeting 8 percent capital adequacy requirement has also come down to 3 during the quarter **(**see **Table-3.2)**. Market share of the banks in terms of total assets of the banking system shows that the share of non-compliant banks is waning and has currently fallen to 5 percent; hence carrying no threat to the solvency of the overall banking system. Moreover, the market share of banks falling in high capital adequacy brackets has also registered a modest increase **(**see **Figure-3.2)**.

Table 3.2 Distribution of Banks by CAR

	Total No. of Banks	Below 8%	8 to 10 %	10 to 15 %	Over 15 %
CY00	44	5	6	16	17
CY01	43	5	5	11	22
CY02	40	4	4	9	23
CY03	40	4	10	5	21
Mar-04	40	3	11	6	20

Figure-3.2: Banks' Market Share by CAR



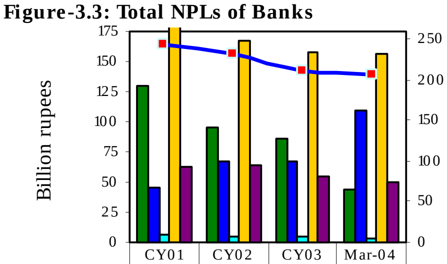
3.2 Non-Performing Loans[2]

The quarter under review witnessed only a marginal decrease in gross NPLs of commercial banks which reduced from Rs157.2 billion as of December 31, 2003 to Rs156.6 billion as of March 31, 2004. However, it is quite significant in terms that despite a considerable growth in loans of the banking system the flow of fresh NPLs has been rather stemmed (see **Figure-3.3**). There was a

[2] *Global operations.*

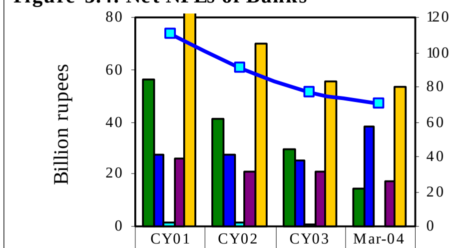
simultaneous increase in the volume of provisions held against bad loans, and the net NPLs came down from Rs55.4 billion as on December 31, 2003 to Rs53.1 billion as of end of this quarter (see **Figure-3.4**).

Figure-3.3: Total NPLs of Banks



	CY01	CY02	CY03	Mar-04
PSCBs	129.6	95.5	85.9	44.0
LPBs	45.7	66.9	67.4	108.8
FBs	6.1	5.2	4.0	3.7
CBs	181.4	167.6	157.2	156.6
SBs	62.7	63.9	54.1	50.4
All (RHS)	244.1	231.5	211.3	207.0

Figure-3.4: Net NPLs of Banks



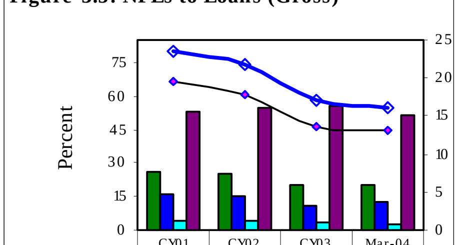
	CY01	CY02	CY03	Mar-04
PSCBs	56.2	41.0	29.4	14.5
LPBs	27.2	27.7	25.1	38.3
FBs	1.6	1.4	0.9	0.4
SBs	25.6	21.2	21.2	17.0
CBs	85.0	70.1	55.4	53.1
All (RHS)	110.5	91.3	76.7	70.1

NPLs (both gross and net) of PSCBs have decreased sharply, whereas for LPBs, these have increased by the same proportion. However, this is merely due to reclassification of HBL under LPBs in March-04 quarter, which was previously being shown in PSCBs.

The commercial banks were able to post handsome cash recoveries of Rs5.8 billion in this quarter, though this performance was offset by an addition of fresh NPLs to the existing stock.

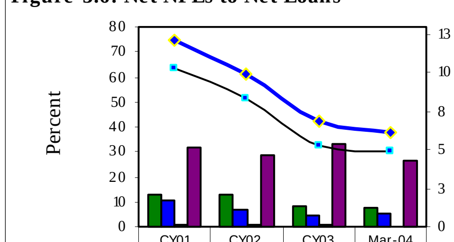
Despite a significant pickup in consumer credit recently, the level of new infection in

Figure-3.5: NPLs to Loans (Gross)



	CY01	CY02	CY03	Mar-04
PSCBs	25.9	25.5	20.4	20.6
LPBs	16.3	15.4	11.3	13.0
FBs	4.3	3.8	3.1	2.8
SBs	53.0	54.7	55.6	51.5
CBs (RHS)	19.6	17.7	13.7	13.2
All (RHS)	23.4	21.8	17.0	16.1

Figure-3.6: Net NPLs to Net Loans

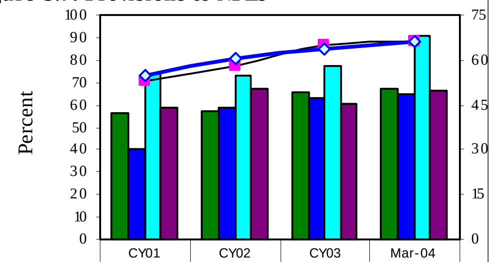


	CY01	CY02	CY03	Mar-04
PSCBs	13.1	12.8	8.1	7.8
LPBs	10.4	7.0	4.5	5.0
FBs	1.1	1.1	0.7	0.3
SBs	31.5	28.5	33.0	26.4
CBs(RHS)	10.3	8.3	5.3	4.9
All (RHS)	12.1	9.9	6.9	6.1

credit portfolio is not disturbing. NPLs to loans ratio for all banks has slightly improved. The ratio of net NPLs to net loans looks healthier for all groups except LPBs for which it deteriorated from 4.5 percent to 5.0 percent during the quarter (see **Figures 3.5 & 3.6**). However, a gross reduction of Rs3.7 billion and addition of Rs0.5 billion in provisions by SBs helped the ratio of net NPLs to net loans of all banks improve from 6.9 percent in the last quarter to 6.1 percent in the current quarter.

The NPL coverage ratios for all the different groups have also witnessed a continued improving pattern. From the point of view of credit risk mitigation, it is quite heartening to note that now almost two-thirds of all NPLs in banks are provided for and the rest are largely covered by collaterals. The rising coverage ratios have been depicted in **Figure-3.7**

Figure-3.7: Provisions to NPLs



	CY01	CY02	CY03	Mar-04
PSCBs	56.6	57.1	65.8	67.2
LPBs	40.5	58.6	62.7	64.8
FBs	74.1	73.3	77.4	90.4
SBs	59.2	66.9	60.8	66.2
CBs(RHS)	53.2	58.2	64.7	66.1
All (RHS)	54.7	60.6	63.7	66.1

3.3 Profitability

The banking system remained on the course of profitability during the first quarter of CY04. The key performance indicators, however, show a comparative decline if seen against the outstanding performance witnessed during CY03. Pre-tax profit at Rs8.1 billion, while commendable, amounts to 18.2 percent of the pre-tax profit registered in CY03. This led to a fall in ROA and ROE to 0.6 percent (CY03: 1.1 percent) and 11.5 percent (CY03: 20.5 percent) respectively.

Table-3.3: Profitability of Banking System

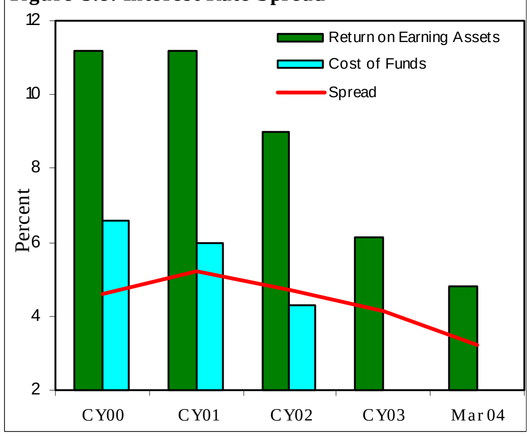
Billion rupees	CY00	CY01	CY02	CY03	Mar-04
Profit before tax					
PSCBs	3.9	0.2	10.9	16.1	2.3
LPBs	-0.6	5.0	11.9	23.8	7.0
FBs	3.7	5.0	6.6	7.1	1.3
Comm. Banks	7.0	10.3	29.4	47.1	10.6
SBs	-2.5	-9.2	-10.4	(2.5)	(2.5)
All Bank	4.5	1.1	19	44.6	8.1
Profit after tax					
PSCBs	1.8	-4.6	4.8	9.4	1.3
LPBs	-3.5	2.0	6.4	14.8	4.6
FBs	1.4	2.4	4.2	4.2	0.8
Comm. Banks	-0.2	-0.2	15.3	28.4	6.7
SBs	-2.6	-9.5	-12.4	(3.2)	(2.6)
All Banks	-2.8	-9.8	2.9	25.1	4.1

Non-interest income, particularly gain on sale of securities, was the main reason behind high profits for the previous year. However, gradual rise in yields on government securities since the last quarter, started to reduce the opportunities of making similar gains. Consequently, the proportion of non-interest income to gross income of all banks fell to 38.8 percent from 39.5 percent in CY03. More pronounced was the fall in the share of capital gains to 10.3 percent from 15.4 percent in CY03.

All this was bound to reduce the overall profits, as core earnings could not come up to expectations to make up for the deficit from non-core earnings.

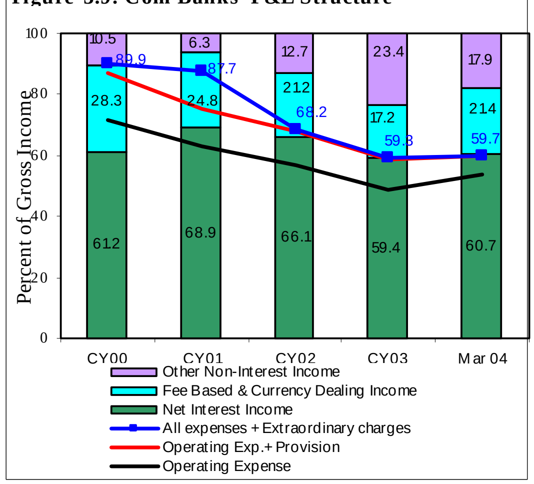
Net interest income, which was expected to rise following a rapid increase in loans over the last few quarters, could not grow enough to make up for the comparatively lower capital gains. Further decline in weighted average lending rates during the quarter provides the possible explanation. The presence of excess liquidity, possible lagged effect and intense competition among banks to capture market share, maybe the plausible factors responsible for the persistent decline in lending rates. Along with the fast growth of earning assets, all these factors caused a reduction in return on average earning assets for all banks to 4.8 percent during the quarter-ended March 2004, from 6.1 percent in CY03. At the same time, the persistent inflow of deposits enabled the banking system to reduce their cost of funds. The fall in cost of funds which went down to 3.2 percent from 4.1 percent in CY03, however, was not enough to keep the overall spread intact (see **Figure-3.8**).

Figure-3.8: Interest Rate Spread



A much better picture emerges for commercial banks if we exclude specialized banks' losses. ROA and ROE for all commercial banks come to 1.1 percent (CY: 1.2 percent) and 17.4 percent (20.5 percent) respectively, which highlights only a marginal fall in the two key ratios. The profit and loss structure of all commercial banks reveals that the share of net interest income in gross income of all commercial banks has increased to 60.7 percent from 59.4 percent during CY03 (see **Figure-3.9**). Like CY03, it covers all the expenses incurred by the commercial banks.

Figure-3.9: Com Banks' P&L Structure



Operating expenses, in absolute terms, do not show any deviation from the past trend. However, the comparative lower gross income during the quarter transpired into a high ratio of operating expenses to gross income (see **Table-3.4**). Intermediation cost remained at the previous year's level largely because of fast growth in deposits. Gradually improving asset quality has also helped in reducing provision expense of the commercial banks. Provision to gross income ratio of all commercial banks stood at 6.1 percent as on end March 2004, down from 10 percent in CY03. Despite the fact that banks generally make higher provision at year-end, the ratio exhibits a persistent decline since CY01 when banks were providing almost a quarter of their gross income against bad loans.

Table-3.4: Earnings and profitability indicators

(Percent)	CY00	CY01	CY02	CY-03	Mar-04
Before Tax ROA					
PSCBs	0.5	0.0	1.3	1.8	1.2
LPBs	-0.1	0.9	1.4	2.2	2.0
FBs	1.4	1.7	2.3	2.6	1.9
Comm. Banks	0.4	0.6	1.5	2.1	1.7
SBs	-2.3	-8.4	-10.2	-2.5	-10.1
All Banks	0.3	0.1	0.9	1.9	1.3
Before Tax ROE					
PSCBs	10.9	0.5	26.3	29.9	19.0
LPBs	-3.2	25.4	32.3	42.2	36.1
FBs	15.6	19.3	24.2	25.2	19.4
Comm. Banks	8.8	12.2	27.5	33.9	27.8
SBs	-	-	-	-	-
All Banks	5.7	1.4	21.1	36.4	22.5
ROA (after tax)					
PSCBs	0.2	-0.5	0.6	1.02	0.7
LPBs	-0.7	0.4	0.8	1.4	1.3
FBs	0.6	0.8	1.5	1.5	1.3
Comm. Banks	0.0	0.0	0.8	1.2	1.1
SBs	-2.3	-8.8	-12.1	-3.2	-10.1
All Banks	-0.2	-0.5	0.1	1.1	0.6
ROE (after tax)					
PSCBs	4.9	-12.2	11.5	17.3	10.5
LPBs	-17.6	10.3	17.3	26.2	23.4
FBs	6.1	9.1	15.2	14.9	12.6
Comm. Banks	-0.3	-0.3	14.3	20.5	17.4
SBs	-	-	-	-	-
All Banks	-3.5	-12.6	3.2	20.51	11.5
Net Interest Margin					
PSCBs	3.6	4.3	4.0	3.7	2.3
LPBs	3.4	4.3	4.3	3.5	3.4
FBs	3.2	3.3	3.1	3.4	3.2
Comm. Banks	3.5	4.1	3.8	3.5	3.1
SBs	3.2	3.3	7.5	7.1	3.3
All Banks	3.5	4.3	4.0	3.7	3.1
Operating Exp. to Gross Income (NII +Non-interest Income)					
PSCBs	70.1	62.3	56.9	42.8	48.6
LPBs	80.9	67.3	60.0	53.2	55.5
FBs	59.4	54.5	45.4	48.3	50.9
Comm. Banks	71.6	62.7	56.7	48.6	53.6
SBs	70.5	59.0	84.7	55.6	124.1
All Banks	71.6	62.4	59.1	49.1	56.0
Intermediation cost					
PSCBs	3.4	3.2	2.9	2.3	1.5
LPBs	3.9	3.6	3.2	2.9	3.1
FBs	2.9	2.5	2.3	2.8	2.8
Comm. Banks	3.4	3.2	3.0	2.6	2.6
SBs	3.2	3.9	7.3	3.6	4.1
All Banks	3.4	3.2	3.2	2.7	2.7

The group-wise position shows dominance of local private banks (LPBs) on the profitability front also. They account for around 69 percent of the total after-tax profit of all commercial banks. HBL's category shift, following its sell off, also helped in increasing their share in the overall profits of the banking system. Moreover, this group also appears almost on the same profit trajectory. The public sector commercial banks (PSCBs) and foreign banks appear to be falling behind in this context. Specialized banks incurred losses for the current quarter as well. The restructuring exercise and gradual improvement in the financial health of the largest specialized bank is expected to reduce losses of this group in future.

3.4 Liquidity

With easeful liquidity around, the conventional indicators for liquidity still remained benign as even after noticeable upsurge in credit, the credit to deposit ratio stood at 56.6 percent, marginally up from 56.5 percent of Dec-03. Balance sheet structure also largely remained unchanged. Liquid assets to total assets ratio underwent minor adjustment and eased of by 1 percentage point to 44.1 percent (see **Figure-3.10**), while liquid assets held in excess of statutory requirement remained as high as 96.7 percent (see **Figure-3.11**)

There has been a noticeable scaling in the yield on the government papers (especially in post quarter developments). The resultant impact of this on profitability of the banks is quite visible with fast depleting surplus on revaluation account. Nonetheless, banks remained remarkably resolute against the temptation of excess liquidity for over so long a period. Any concern of their caving in to this in the wake of exponential growth in credit remains unsubstantiated as yet.

Figure-3.10: Liquidity Indicators

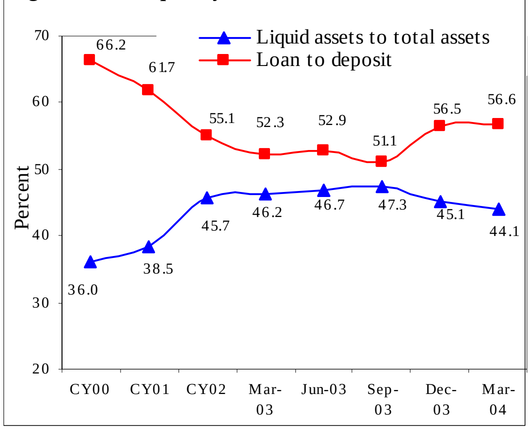
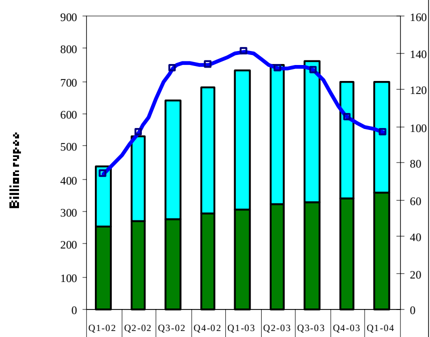


Figure-3.11: Liquidity Held by Banks



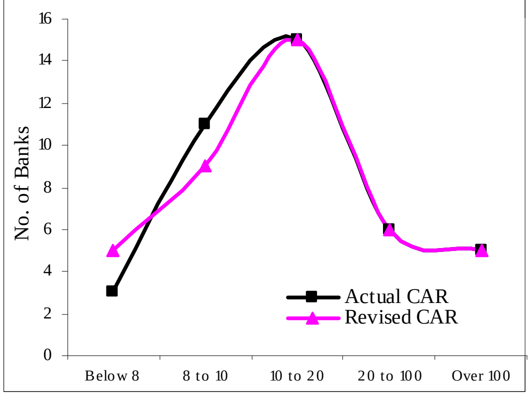
	Q1-02	Q2-02	Q3-02	Q4-02	Q1-03	Q2-03	Q3-03	Q4-03	Q1-04
Surplus	188	259	364	389	429	425	432	356	344
Required	253	270	277	292	305	325	332	341	356
Surplus %of Req. (RHS)	74	96	131	133	141	131	130	104	97

3.5 Market Risk

Of the three major components of market risk, interest rate risk poses the greater threat to our financial system. Since interest rates were already bottomed out, which is reflected in the negative real returns to depositors, the falling interest rate scenario was reversed since August 2003.

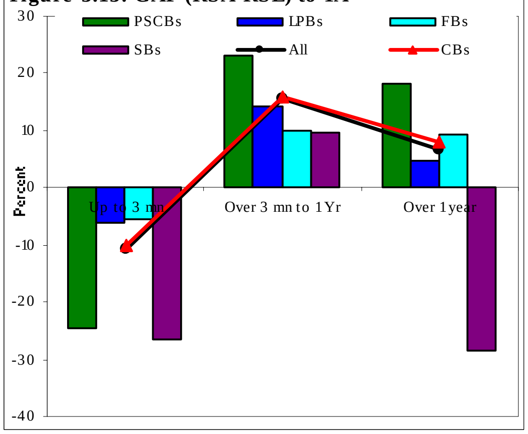
This creates a concern for the asset-sensitive position of the banks, especially for those with large holdings of fixed income government securities. Investment in PIBs though dropped since December 2003, but the level is still high given the changing interest rate scenario. Though the weighted average duration of PIBs for all the five maturities has been falling since the interest rates are increasing, its level at 4.73 years by the end of March 04, is still high. Consequently, the price sensitivity of these securities was high. The price yield relationship of these bonds suggests that 100 bp rise in the interest rate could lower the value of 3, 5, 10, 15 and 20 years bonds by around 1.33, 2.93, 5.54, 8.10 and 8.68 percent respectively. On Market Treasury Bills (MTBs) the weighted average fall in the value remains at 0.41 percent due to its lower value of duration. When the impact of PIBs and MTBs is realized in the capital adequacy ratio of the banks, 22 banks would face deterioration in their CAR if timely corrective measures are not taken by them (see **Figure-3.12**).

Figure-3.12: Impact of fall in PIBs and MTBs value on CAR



The GAP between rate sensitive assets and rate sensitive liabilities, when measured as a percentage of total assets, stayed within the acceptable benchmark of +/- 10 percent for the three-month period. However, the positive GAP for the next two buckets of three months to one year and over one year period exceeded the limit (see **Figure-3.13**). This signifies positive maturity GAP that could negatively affect the net worth of the banks in case the interest rates moves up.

Figure-3.13: GAP (RSA-RSL) to TA



The Rupee persisted to hold gains against the US dollar and resided strong. However, the negative swap points prompted banks to hold short positions. Though the exposure is not that large, negative net open positions (NOP) of the banks may create an exchange rate risk if not squared in a timely manner.

Capital market remained buoyant and continues to register new heights. The driving factors were surplus liquidity that raised asset prices and the low cost of funds, fuelling corporate performance, hence the value of their shares. Given the higher returns in the equity market, banks preferred to have an increased investment in the capital market, which at end March 04 stood at Rs33 billion. The direct exposure of the banks in terms of investment in fully paid up shares at 22 percent of their equity is quite significant particularly if the volume of indirect exposure in the form of carryover transactions (COTs) is also taken into account which raises the total exposure to 30 percent of the equity. Given the volatile disposition of the equity market where direct exposure could create equity price risk, the indirect exposure in the capital market, if not properly managed, may lead to credit risk.

Appendix-I

Glossary

Capital adequacy ratio The amount of risk-based capital (Tier I and II) as a percent of risk-weighted assets.

Corporate Corporate means and includes public limited companies and such entities, which do not come under the definition of SME.

Discount rate It is the rate at which SBP provides three-day repo facility to the banks, acting as the lender of last resort.

GAP Term commonly used to describe the rupee volume of the interest-rate sensitive assets versus interest-rate sensitive liabilities mismatch for a specific time frame; often expressed as a percentage of total assets.

Inter-bank rates The two way quotes namely bid and offer rates quoted in inter-bank market are called as inter-bank rates.

Intermediation cost Administrative expenses divided by the average deposits and borrowings.

Liquid assets The assets that are easily and cheaply turned into cash – notably cash and short term securities. It includes cash and balances with banks, call money lending, lending under repo and investment in government securities.

Net interest income Total interest income less total interest expense. This residual amount represents most of the income available to cover expenses other than interest expense.

Net interest margin (NIM) Net interest income as a percent of average earning assets.

Net loans Loans net of provision held for non-performing loans.

Net non-performing loans (NPLs) The value of non-performing loans minus provision for loan losses.

Net NPLs to net loans Net NPLs as a percent of net loans. It shows the degree of loans infection after making adjustment for provision held.

Non-Performing loans (NPLs) Loans and advances whose mark-up/interest or principal is overdue by 90 days or more from the due date are classified as non-performing.

NPLs to loans ratio Non-performing loans as a percent of gross loans.

Paid-up capital This is equity amount actually paid by the shareholders to a company for acquiring its shares.

Rate sensitive assets (RSA) Assets susceptible to interest rate movements; that will be repriced or will have a new interest rate associated with them over the forthcoming planning period.**Return on assets** It measures the operating performance of an institution. It is the widely used indicator of earning and is calculated as net profit as percentage of average assets.

Risk weighted Assets Each asset and off-balance sheet item is assigned to one of the four broad risk categories based on the perceived credit risk of the obligor. These risk categories are assigned weights of 0 percent, 20 percent, 50 percent and 100 percent. The standard risk category is 100 percent. The rupee value of the amount in each category is multiplied by the risk weights associated with that category. The off-balance sheet items are first converted to credit equivalent values by using the conversion factors. The resulting values for each of the risk categories are added together. The resulting sum is the total risk weighted assets.

SME: means an entity, ideally not a public limited company, which does not employ more than 250 persons (if it is manufacturing concern) and 50 persons (if it is trading / service concern) and also fulfils the following criteria of either 'a' and 'c' or 'b' and 'c' as relevant:

(a) A trading / service concern with total assets at cost excluding land and building upto Rs50 million.
(b) A manufacturing concern with total assets at cost excluding land and building upto Rs100 million.
(c) Any concern (trading, service or manufacturing) with net sales not exceeding Rs300 million as per latest financial statements.

Tier I capital The risk based capital system divides capital into two tiers- core capital (Tier I) and supplementary capital (Tier II). Tier I capital is defined as common stockholders' equity (including common stock, surplus and undivided profits), non-cumulative perpetual preferred stock and minority interest in consolidated subsidiaries.

Tier II capital Supplementary Capital (Tier II) is limited to 100 percent of core capital (Tier I). It includes cumulative perpetual preferred stock, mandatory convertible debt, the general provision or reserves for loan losses, term subordinated debt, limited life preferred stock and other hybrid capital instruments.

Yield risk The risk arising out of the changes in interest rates on a bond or security when calculated as that rate of interest which, if applied uniformly to future time periods sets the discounted value of future bond coupon and principal payments equal to the current market price of the bond.

Appendix-II

Abbreviations

CAR	Capital Adequacy Ratio
CBs	Commercial Banks
CY	Calendar year
FBs	Foreign Banks
LPBs	Local Private Banks
MCR	Minimum Capital Requirement
MTBs	Market Treasury Bills
NII	Net Interest Income
NPLs	Non Performing Loans
OMOs	Open Market Operations
PIBs	Pakistan Investment Bonds
PSCBs	Public Sector Commercial Banks
PTCs	Participation Term Certificates
ROA	Return on Assets
ROE	Return on Equity
RSAs	Rate Sensitive Assets
RSLs	Rate Sensitive Liabilities
RWA	Risk Weighted Assets
SBP	State Bank of Pakistan
SBs	Specialized Banks
SMEs	Small and Medium Enterprises
TFCs	Term Finance Certificates
ZTBL	Zarai Taraqiati Bank Limited

Appendix-III

Group-wise Composition of Banks

2001	2002	2003	31-03-2004
A. Public Sector Comm. Banks Habib Bank Ltd. National Bank of Pakistan United Bank Ltd.[2] First Women Bank Ltd. The Bank of Khyber The Bank of Punjab **B. Local Private Banks** Askari Commercial Bank Ltd. Bank Al-Falah Ltd. Bank Al Habib Ltd. Bolan Bank Ltd. Faysal Bank Ltd. Metropolitan Bank Ltd. Platinum Commercial Bank Ltd[5] Prime Commercial Bank Ltd. Saudi Pak Commercial Bank Ltd[1] PICIC Commercial Bank Ltd. Soneri Bank Ltd. Union Bank Ltd. Muslim Commercial Bank Ltd. Allied Bank of Pakistan **C. Foreign Banks** ABN Amro Bank Al Baraka Islamic Bank American Express Bank Ltd. Standard Chartered Grindlays Bank[6] Bank of Ceylon The Bank of Tokyo – Mitsubishi Citibank, N.A. Credit Agricole Indosuez Deutsche Bank A.G. Doha Bank Emirates Bank[4] Habib Bank A. G. Zurich The Hongkong & Shanghai Banking Corporation Ltd. IFIC Bank Ltd. Mashreq Bank PJSC Oman International Bank S.A.O.G Rupali Bank Ltd. Societe Generale[3] Standard Chartered Bank **D. Specialized Banks** Agriculture Development Bank of Pakistan Industrial Development Bank of Pakistan Federal Bank for Co-Operatives[7] Punjab Provincial Co-operative Bank Ltd. **All Commercial Banks** Includes A + B + C **All Banks** Includes A + B + C + D	**A. Public Sector Comm. Banks** Habib Bank Ltd. National Bank of Pakistan First Women Bank Ltd. The Bank of Khyber The Bank of Punjab **B. Local Private Banks** Askari Commercial Bank Ltd. Bank Al-Falah Ltd. Bank Al Habib Ltd. Bolan Bank Ltd. Faysal Bank Ltd. Metropolitan Bank Ltd. KASB Bank Ltd. Prime Commercial Bank Ltd. Saudi Pak Commercial Bank Ltd PICIC Commercial Bank Ltd. Soneri Bank Ltd. Union Bank Ltd. Muslim Commercial Bank Ltd. Allied Bank of Pakistan United Bank Ltd. Meezan Bank **C. Foreign Banks** ABN Amro Bank Al Baraka Islamic Bank American Express Bank Ltd. Bank of Ceylon The Bank of Tokyo – Mitsubishi Citibank, N.A. Credit Agricole Indosuez Deutsche Bank A.G. Doha Bank Habib Bank A. G. Zurich The Hongkong & Shanghai Banking Corporation Ltd. IFIC Bank Ltd.[9] Mashreq Bank PJSC[8] Oman International Bank S.A.O.G Rupali Bank Ltd. Standard Chartered Bank **D. Specialized Banks** Zari Taraqiati Bank Ltd. Industrial Development Bank of Pakistan Punjab Provincial Co-operative Bank Ltd. **All Commercial Banks** Includes A + B + C **All Banks** Includes A + B + C + D	**A. Public Sector Comm. Banks** Habib Bank Ltd[10] National Bank of Pakistan First Women Bank Ltd. The Bank of Khyber The Bank of Punjab **B. Local Private Banks** Askari Commercial Bank Ltd. Bank Al-Falah Ltd. Bank Al Habib Ltd. Bolan Bank Ltd. Faysal Bank Ltd. Metropolitan Bank Ltd. KASB Bank Ltd. Prime Commercial Bank Ltd. Saudi Pak Commercial Bank Ltd PICIC Commercial Bank Ltd. Soneri Bank Ltd. Union Bank Ltd. Muslim Commercial Bank Ltd. Allied Bank of Pakistan United Bank Ltd. Meezan Bank NDLC-IFIC Bank Ltd Mashreq Bank Ltd. **C. Foreign Banks** ABN Amro Bank Al Baraka Islamic Bank American Express Bank Ltd. Bank of Ceylon[11] The Bank of Tokyo – Mitsubishi Citibank, N.A. Credit Agricole Indosuez Deutsche Bank A.G. Doha Bank Habib Bank A. G. Zurich The Hongkong & Shanghai Banking Corporation Ltd. Oman International Bank S.A.O.G Rupali Bank Ltd. Standard Chartered Bank **D. Specialized Banks** Zari Taraqiati Bank Ltd. Industrial Development Bank of Pakistan Punjab Provincial Co-operative Bank Ltd. **All Commercial Banks** Includes A + B + C **All Banks** Includes A + B + C + D	**A. Public Sector Comm. Banks** National Bank of Pakistan First Women Bank Ltd. The Bank of Khyber The Bank of Punjab **B. Local Private Banks** Askari Commercial Bank Ltd. Bank Al-Falah Ltd. Bank Al Habib Ltd. Bolan Bank Ltd. Dawood Bank Ltd. Faysal Bank Ltd. Habib Bank Ltd Metropolitan Bank Ltd. KASB Bank Ltd. Prime Commercial Bank Ltd. Saudi Pak Commercial Bank Ltd PICIC Commercial Bank Ltd. Soneri Bank Ltd. Union Bank Ltd. Muslim Commercial Bank Ltd. Allied Bank of Pakistan United Bank Ltd. Meezan Bank NDLC-IFIC Bank Ltd Mashreq Bank Ltd. **C. Foreign Banks** ABN Amro Bank Al Baraka Islamic Bank American Express Bank Ltd. The Bank of Tokyo – Mitsubishi Citibank, N.A. Credit Agricole Indosuez[12] Deutsche Bank A.G. Doha Bank[13] Habib Bank A. G. Zurich The Hongkong & Shanghai Banking Corporation Ltd. Oman International Bank S.A.O.G Rupali Bank Ltd. Standard Chartered Bank **D. Specialized Banks** Zari Taraqiati Bank Ltd. Industrial Development Bank of Pakistan Punjab Provincial Co-operative Bank Ltd. **All Commercial Banks** Includes A + B + C **All Banks** Includes A + B + C + D

1. *Prudential Commercial Bank was acquired by Saudi-Pak Industrial & Agricultural Investment Company and renamed as Saudi-Pak Commercial Bank Ltd. - 05-11-2001.*
2. *On its privatization, UBL shifted from PSCB to LPB in 2002.*
3. *Societe Generale - Pakistan Operations – were acquired by Meezan Bank Ltd. – 30-04-2002.*
4. *Emirates Bank International – Pakistan Operations were purchased by Union Bank Ltd. – 02-09-2002.*
5. *Platinum Commercial Bank Ltd. was purchased by KASB and renamed as KASB Bank Ltd. – 17-10-2002.*
6. *ANZ Grindlays Bank was merged into / acquired by Standard Chartered – 30-11-2002.*
7. *FBC is under liquidation, hence excluded from 2002.*
8. *Mashreq Bank, after merger with Crescent Investment Bank, converted to a local private bank in 2003.*
9. *IFIC, after merger with NDLC, converted to NDLC-IFIC Bank Ltd in local banks on 03-10-2003.*
10. *HBL now stands as local private bank after being privatized on 26-02-2004.*
11. *Bank of Ceylon now stands as local private bank after being merged into Dawood Bank on 25-03-2004.*
12. *Credit Agricole now stands as local private bank after being merged into NDLC-IFIC Bank on 19-04-2004.*
13. *Doha Bank now stands as local private bank after being merged into Trust Bank on 05-05-2004.*